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July 19, 2004

TO: **Dan R. Bucks**
Multistate Tax Commission

FROM: **Ellen B. Marshall**
James C. Rosapepe

RE: **Federal Legislative Activities Report**

(Note: During the timeperiod of writing of this report and the Executive Committee meeting, action on several issues discussed below—including the ITFA moratorium and VoIP legislation—could occur. Thus, updated information will be provided at the Executive Committee meeting.)

Congress has now begun its summer recess, which will extend this year thru September 7th to accommodate the political conventions of both parties. Prior to adjourning, the House and Senate made very little progress in resolving their differences on a number of key pieces of legislation, leaving them just 12 legislative days in September to wind up their work—or find an alternative exit strategy to keep the government functioning for several months. At this point in time, only two (Defense and Homeland Security) of the annual federal appropriations measures have been approved and the House and Senate have not yet conferenced 35 pieces of tax-related legislation that have been approved by the respective chambers.

While Congress continues to be in a state of gridlock on numerous issues, it does continue to turn its attention to numerous topics of interest to state tax authority. Following is a status report on those issues.

Extension of the Moratorium on Taxation of Internet Access Charges. In late April, the Senate approved legislation that will provide a four-year extension of the moratorium on state taxation of consumer charges for Internet access. The Senate legislation is in stark contrast to legislation approved earlier by the House which would provide a permanent moratorium. Following is a breakdown of the key provisions in the House/Senate legislation:

- **Bill Number: Senate**: S. 150; **House**: HR 49

- **Length of moratorium extension**: **Senate**: four years (from the date of the expiration of the current law), expiring in October 2007; **House**: permanent

- **Retention of Grandfather Clauses: Senate**: retains grandfather clause for existing taxes on traditional dial-up access for four years; retains grandfather clause for existing taxes on DSL for two years; **House**: repeals grandfather clauses

- **Definition of "Internet Access": Senate**: revises the definition of "Internet access" to insure that the moratorium applies only to sales and use taxes imposed on access charges; also modifies the definition to insure that state taxes applied to Voice over Internet Protocol services are not preempted; **House**: expands current definition of "Internet access" to preempt state taxes on Voice over Internet Protocol services.

The next step toward resolution on this issue will be the House and Senate appointing a committee of conferees to work out differences between the two measures. As of the writing of this report, no conferees have been named. Additionally, the Senate is putting heavy pressure on the House to simply accept the Senate version of the legislation—which would allow both sides to avoid conference negotiations. However, the House leadership has been unwilling to consider such an offer.

This issue could be resolved in a matter of days, or months. Regardless of the timeline, we will continue to provide you with timely updates on progress toward resolution.

Taxation of Voice over Internet Protocol (VoIP). Legislation has been introduced in both the House (HR 4129, introduced by Rep. Pickering, R-MS) and Senate (S. 2281, introduced by Sen. Sununu, R-NH) that seeks to restrict state/federal regulation and state taxation of Voice over Internet Protocol services. Specifically, both the House and Senate legislation would:

- Prohibit state and local taxation of VoIP services;
- Assert federal jurisdiction to regulate VoIP;
- Preempt Federal Communications Commission authority over VoIP;
- Allow the industry to self-govern itself on issues such as participation in the provision of 911 services, security measures, and reliability standards for VoIP.

On June 16, the Senate Commerce Committee held a hearing on the regulatory aspects of VoIP. Witnesses at the hearing included representatives of the Department of Justice, law enforcement, the VoIP industry, and state utility commissioners. Discussion at the Senate hearing focused almost exclusively on problems that could result from allowing the industry to be self-governing and also on the difficulties the federal government could face if federal regulations on wiretapping and other law enforcement mechanisms were not applied with the same force to VoIP as they are to other telecommunications services. The issue of state taxation of VoIP was not addressed at the hearing with the exception of concerns expressed about preempting state tax authority in the opening statements of several senators on the Committee (i.e., Sens. Stevens (R-AK), Dorgan (D-ND), and Lautenberg (D-NJ). On July 22, 2004, the Senate Commerce Committee will markup S. 2281 and take a vote on final passage in the Committee. A copy of correspondence sent to the Committee in opposition to the tax provisions in S. 2281 by the MTC and Federation of Tax Administrators is attached. An update on the Commerce Committee markup will be provided at the Executive Committee meeting.

On July 7th, the Subcommittee on Telecommunications and the Internet of the House Energy and Commerce Committee held a hearing on HR 4129. Witnesses at this hearing represented the same constituencies that appeared before the Senate Commerce Committee, i.e., the federal regulators, public utility commissioners, and industry representatives. Due to the jurisdictional restraints of the Energy and Commerce Committee, the issue of state taxes on VoIP was not addressed at this hearing.

On July 23, 2004, the Subcommittee on Commercial and Administrative Law of the House Judiciary Committee is scheduled to hold a hearing on the regulatory aspects of VoIP. An update on the Subcommittee hearing will be provided at the Executive Committee meeting.

A copy of correspondence from five state and local government organizations in opposition to HR 4129 is attached to this report.

Streamlined Sales Tax System Federal Legislation. As previously reported, legislation has been introduced in both the House (HR 3184) and Senate (S 1736) to provide collection authority for sales and use taxes on remote sales to states that comply with the terms of the Streamlined Sales Tax Implementing States Agreement. To date, neither the House nor Senate legislation has received a hearing in this Congress.

While legislative activity in Congress on this issue has been lax, state and local governments have continued to meet with representatives of the business community to make changes to the federal legislation. These discussions have yielded significant progress toward insuring that the federal legislation reflects an accurate interpretation and implementation of the SSTIS Agreement. However, several areas of disagreement remain—specifically on issues of federal courts jurisdiction, small seller exceptions, vendor compensation, audit, seller registration, and telecommunications provisions. (These issues may be discussed in more detail during the Executive Committee meeting.)

In state legislatures, Michigan recently approved legislation to become a member to the SSTIS Agreement, bringing the total number of states who have changed their laws to conform to the Agreement to 21. With the addition of Michigan, states have surpassed the threshold requirements set forth in the Agreement in terms of both number and population percentage. Most state legislatures have completed their 2004 sessions, and it is doubtful that any of the states still in session will approve similar measures this year.

Federal Business Activity Tax Legislation. On May 13, the Subcommittee on Commercial and Administrative Law of the House Judiciary Committee held a hearing on HR 3220, the Business Activity Tax Simplification Act of 2003. HR 3220 seeks to impose a physical presence nexus standard for imposition of state business activity taxes. No companion legislation to HR 3220 has been introduced in the Senate.

Rick Clayburgh, North Dakota State Tax Commissioner, testified on behalf of the National Governors Association at this hearing. Other witnesses included representatives from the Iowa state legislature, the Coalition for Fair and Rational Taxation, and Smithfield Foods. A copy of the statement for the record of the hearing as submitted by the Commission is attached to this memorandum.

The focus of the hearing centered on whether HR 3220 represents, as its proponents claim, a clear, brightline nexus standard which will eliminate confusion in the business community regarding when a company has significant nexus to trigger liability for state business activity taxes. Mr. Clayburgh did an excellent job of outlining the inherent flaws in the legislation and also the potential for widespread revenue losses and increased litigation if HR 3220 is approved.

Although there has been no further legislative action on HR 3220 subsequent to this hearing, proponents continue to actively lobby for its approval, either in the context of a stand-alone measure or as an amendment to federal legislation to implement the SSTIS Agreement.

Tax Shelters. Several measures to curb the use of abusive tax shelters have been included in legislation that has been approved by both the House and Senate. However, no legislation has yet been signed into law and the chance of reaching agreement on tax shelter provisions in this Congress appears slim. S. 1637, Senate legislation to repeal the current U.S. system of export tax breaks, contains several tax shelter-related provisions that would codify and strengthen the economic substance doctrine and increase penalties and disclosure requirements for engaging in tax shelters. In addition, provisions in S. 1637

would require CEOs to sign documents relating to the accuracy of their companies' tax returns. S. 1637 passed the Senate in May by a vote of 92-5. In the House, HR 4520 (the House version of legislation to repeal the current U.S. system of export tax breaks), contains several provisions to require tougher disclosure rules and penalties for abusive tax shelters. However, the House legislation does not codify the economic substance doctrine. The House passed HR 4520 by a vote of 251-78 on June 17—and in doing so made one change to strengthen the tax shelter provisions to state that the identities of tax shelter investors are not privileged.

The House and Senate must now arrange to conference S. 1637 and HR 4520 to arrive, principally, at an agreement on how to implement a new export tax regime. (This is commonly referred to as the "FSC-ETI remedy", which stands for "Foreign Sales Corporation/Extra Territorial Income".[1]) In the process of passing this legislation, both the House and Senate were forced to insert numerous "sweeteners" in their measures to garner enough votes for passage. Thus, there are numerous other tax provisions in these bills—including provisions to allow taxpayers in states without an income tax to deduct sales taxes on their federal returns; provisions to curb the use of sale-in/lease out (SILO) transactions by local governments; charitable deduction provisions; and deductions for certain arrowheads—that will weigh heavily on the political chances of this legislation being approved during this Congress. The tax shelter language in S. 1637 is likely to cause significant controversy during conference negotiations with the House; and while the Administration continues to advocate measures to strengthen promoter penalties, passage of those provisions within this legislation is not the Administration's highest priority. (The Administration has provided no indication of whether it would support codification of the economic substance doctrine.)

Further legislative progress on this issue is not expected until after Congress returns from its summer recess in September.

We hope this information is helpful. If you have any questions or need further information, please do not hesitate to contact us.

[1] In the hallways of Congress, the FSC-ETI legislation has taken on a life of its own, blossoming from a simple remedy bill for an international tax controversy to a voluminous tax measure that addresses over 100 different issues. As such, the measure has garnered numerous nicknames, including the "ET Phone Home Bill", the "Extra-Terrestrial Income Bill", and the "Frisky Business Bill".

National Governors Association
Council of State Governments
National League of Cities
The U.S. Conference of Mayors
National Association of Counties

July 01, 2004

The Honorable Joe Barton
Chairman
Committee on Energy and Commerce
U.S. House of Representatives
Washington, D.C. 20515

The Honorable John D. Dingell
Ranking Member
Committee on Energy and Commerce
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Barton and Representative Dingell:

We urge you not to take action on H.R. 4129, the "VOIP Regulatory Freedom Act of 2004" this year. While the objectives of H.R. 4129 may be well-intended, the bill is a premature response to an emerging technology that fails to adequately address the wide variety of complex issues that face the communications and Internet industries as a whole.

Voice over the Internet technologies (VOIP) and other advanced communications have the potential to provide consumers with more choices among phone services. However, determining the appropriate regulatory treatment for these new technologies will require policymakers to look at these issues holistically, and ideally, develop policy that does not create different rules for different technologies. For example, given predictions that VOIP may replace conventional telephone service in the future, it is important that the state and local government roles promoting the public interest in traditional telecommunications apply equally to VOIP. Unfortunately, H.R. 4129 would preempt virtually all state authority over IP-enabled technology, undermining the roles of state and local government. Specifically, state and local government officials oppose H.R. 4129 because:

- Public safety concerns are a priority for state and local governments, yet H.R. 4129's preemption of state and local authority over E911 services and wiretapping laws would undermine state and local public safety programs.
- The elimination of state and local government from the regulation of VOIP also eliminates the ability of states to provide consumer protections, including access requirements for individuals with disabilities, or promote long-term universal service goals.
- By focusing on one particular technology, H.R. 4129 would artificially create winners and losers within the communications industry, undermining the objective of fair and open competition.

- The preemption of state taxing authority over VOIP services unnecessarily interferes with state sovereignty over state and local revenue issues.
- Finally, unless changes to communications policy are aimed at balancing the playing field for all participants—both new entrants and current players—and take the public interest fully into account, the fast-paced nature of technological developments will ensure that any new technology-specific regulatory structure will become obsolete in a relatively brief period of time.

We believe the Committee needs to take a comprehensive look at all issues facing the communications industry, a look that H.R. 4129 does not afford. History has shown states and local governments to be good stewards in the effort to promote competition and protect the public interest as it relates to the communications industry. While communications platforms may continue to change, the public interest will remain, and state and local governments should continue to be involved in protecting that interest. Thus, we urge the Committee to avoid a rush to judgment this year by not acting on H.R. 4129.

Thank you for your consideration.

Sincerely,

Raymond C. Scheppach
Executive Director
National Governors Association

Donald J. Borut
Executive Director
National League of Cities

Daniel M. Sprague
Executive Director
Council of State Governments

J. Thomas Cochran
Executive Director
The U.S. Conference of Mayors

Larry E. Naake
Executive Director
National Association of Counties

Federation of Tax Administrators

Multistate Tax Commission

July 15, 2004

The Honorable John McCain
Chairman
Senate Commerce, Science and
Transportation Committee
255 Russell Office Building
Washington, DC 20510

The Honorable Ernest F. Hollings, Jr.
Ranking Member
Senate Commerce, Science and
Transportation Committee
560 Dirksen Office Building
Washington, DC 20510

RE: S. 2281, the "Voice over Internet Protocol Regulatory Freedom Act of 2004"

Dear Sens. McCain and Hollings:

We write in opposition to provisions to preempt state taxing authority contained in S. 2281, the Voice over Internet Protocol (VoIP) Regulatory Freedom Act of 2004. The sovereign authority of states to determine their individual tax policies is a core principle of federalism that is essential to the proper balance of the state/federal relationship. Governors and state legislators are best equipped to determine what combination of business climate and tax policy is best suited for their state's economy and the constituents in their jurisdictions. We urge Congress to defer, as it generally has for most of our nation's history, to state officials in determining the appropriate state tax policy in this area. Throughout our history new technologies have been developed and implemented in our economy, and the practice of states determining their own tax policies has not impeded either the implementation of these technologies or the growth of our nation's economy.

In considering whether VoIP services should be subject to state taxes, the Senate has already responded. During the debate on S. 150, the Internet Tax Nondiscrimination Act, sponsors of S. 150 supported—through amended language and floor statements--inclusion of language in the legislation to specifically exclude VoIP from the scope of the moratorium on state and local taxes on Internet access charges. Language to now preempt state taxation of VoIP runs contrary to agreement reached in S. 150.

If the Committee proceeds to take action that runs counter to the earlier established Senate position, it should understand that the potential for harm is great. Specifically, if enacted into law, S. 2281 would preempt state taxing authority and create an unprecedented and unwarranted tax preference for one form of voice communications services over other similar services. This discrimination runs directly counter to the goal of state and federal tax policy to provide a fair and stable marketplace for all consumers and competitors. It will lead to a misallocation of resources in the economy and to calls for further intervention and preemption.

For these reasons, we strongly oppose action by the Committee that will provide preferential state and local tax treatment for VoIP services.

Sincerely,

R. Bruce Johnson
Commissioner
Utah State Tax Commission
Chair
Multistate Tax Commission

Mary Jane Egr
Tax Commissioner
Nebraska Department of Revenue
Chair
Federation of Tax Administrators

cc: (signed copies) All Members, Senate Commerce Committee

Multistate Tax Commission

Statement

of the

Multistate Tax Commission

on

HR 3220

Business Activity Tax Simplification Act

Heard before the
House Judiciary Committee
Subcommittee on Commercial and Administrative Law

on

May 13, 2004

I. Introduction

The Multistate Tax Commission is an organization of state governments that works with taxpayers to administer, equitably and efficiently, tax laws that apply to multistate and multinational enterprises. Created by the Multistate Tax Compact, the Commission is charged by this law with:

- Facilitating the proper determination of State and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes;
- Promoting uniformity or compatibility in significant components of tax systems;
- Facilitating taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration;
- Avoiding duplicative taxation.

Among the tasks delegated to the Commission is the responsibility to recommend uniform nexus standards for the jurisdiction of states to tax multistate companies. Further, the Compact incorporates the Uniform Division of Income for Tax Purposes which provides specific guidance for how income should be divided among the states. In particular, it establishes a policy standard that the income that is reported to a state should "fairly represent" the business activity in that state. This policy standard is an important benchmark used here to evaluate H.R. 3220.

The Commission was created in 1967 as an effort by states to protect their tax authority in the face of previous proposals to transfer the writing of key features of state tax laws from the state legislatures to Congress. For that reason, the Commission has been a voice for preserving the authority of states to determine their own tax policy within the limits of the U.S. Constitution.

Forty-five States (including the District of Columbia) participate in the Commission, as Compact Members (21), Sovereignty Members (3), Associate Members (18), and Project Members (3).

The Commission is pleased to provide its views on HR 3220, the Business Activity Tax Simplification Act.

II. HR 3220 Unravels the Core Principles of Federalism

HR 3220 would have a profound impact on the principles of federalism and the delicate balance in the federal/state relationship. For over 225 years, Congress has recognized the sovereign authority of states to raise revenue. HR 3220 would destroy this core principle and supplant the authority and judgment of state and local elected officials with the judgment of Congress. HR 3220 would result in shifting the entire burden of funding state and local government onto individual state residents and local businesses that, because of their nature, are unable to take advantage of the myriad of tax planning opportunities established in the legislation. Both local and out-of-state businesses impose social costs on state and local infrastructure and it is entirely reasonable for state legislatures to require all businesses to assume a fair share of the cost of supporting those services. As stated earlier, all states currently share this belief and any action

by Congress to summarily invalidate the laws of these states would do great damage to our federal system of government.

III. The Current Doing Business Standard vs. Proposed Physical Presence: Sales and Profits Do Matter

Corporate income taxes and other business activity taxes have been based from their beginning on the twin concepts of taxing income based on the taxpayer's residence and on where income is earned—its source. Source taxation taxes economic activity that occurs within a state regardless of how that activity is conducted. State corporate income taxes are imposed generally either on the "privilege of conducting business" in the state or on "income earned" within the state. The Supreme Court has made very clear that sales into a state are one of the prime factors for determining that income is earned in that state. Courts have affirmed the application of these taxes to those who are participating in a state's economy whether through physical presence or the use of intangibles such as ownership of stock, trademarks, patents, and the like, or by selling a product into a state even in the absence of any property (tangible or intangible) or people in the state.

By advocating that companies should be taxed only where they have a physical presence, proponents of this concept suggest that sales are not an integral part of income-producing activities. It is conceptually and factually wrong to suggest that companies can derive income (and thus, profits) without making sales. Without a market or customers, no sales can occur, no income is generated and no profits are made.

With respect to multistate companies, states, with the full support and encouragement of the U.S. Supreme Court, have developed over the last eight decades a functional, fair, and equitable system of attributing income among the states in which such companies do business. That system consists of apportioning income—sharing the tax base—through formulas based on real economic activities engaged in by the company: property, payroll and sales. The Supreme Court has been very protective to insure that states do not discriminate against multistate businesses and has also made sure that state taxes are fairly apportioned.

One important goal of the system of income taxation established by the states is to ensure equal treatment between out-of-state companies doing business in a state and local businesses. Ideally, if an out-of-state company and a local business both earn $100,000 of profits from within a state, that amount of income should be taxed equally by the state. This goal of equity is especially important when the two businesses compete directly with each other for the same customers. Unfortunately, H.R. 3220 would result in a large number of cases where the $100,000 profit earned in a state by the out of state company would become effectively exempt from taxation, while the tax burden would continue to fall on the local business.

H.R. 3220 would disrupt the proper functioning of this long standing state income tax system by allowing companies to artificially shift income away from where a company is earning the income to tax haven locations. H.R. 3220 establishes a system of "headquarters only" taxation that is directly counter to the system of sharing the tax base among the states where real economic activity is occurring. A "headquarters only" system is a colonial concept of taxation

that allows companies to earn income and benefit from the services of other jurisdictions, but does not ask them to make a fair payment for the use of those public services.

H.R. 3220 purports merely to simplify tax rules by establishing a bright line nexus standard. This characterization is wrong on many counts. The legislation does not establish a bright line of physical presence but contains many exceptions where even taxpayers that have clear and substantial physical presence would be protected by the legislation from paying tax on the income they earn in a state. Moreover, physical presence is inevitably an unworkable standard as all the litigation that has followed from the *Quill Corp. v. North Dakota* decision has shown. Fundamentally, even remote businesses find they need to have contacts in a state to service their customers or to protect their interests. Businesses use sales representatives in states to increase sales. They hire attorneys to sue customers who have not paid. They send in employees or agents to perform installation or warranty work. The supposed "abuse" cited by the Smithfield Farms witness at the hearing was really an indictment of P.L. 86-272, not of the New Jersey tax agency. The company clearly had a physical presence in New Jersey when it was stopped for tax purposes. The company argued that its activities were limited to those protected by P.L. 86-272, but that could not be determined except after the fact. The dispute in that instant was a precursor to expanded disputes that would occur under H.R. 3220, where a company would for all outward appearances have a physical presence, but would claim that it was exempt under the numerous provisions purportedly defining physical presence. In other words, a bright line physical presence would not necessarily be a physical presence under the bill. How is a tax agency supposed to determine that a physical presence exists? Physical presence can also be hidden and manipulated by less responsible taxpayers in ways that invite abuse. It is not easy for state tax agencies to discover physical presence. Thus, in practice, a physical presence standard leads not to equitable certainty in the application of the law, but to uneven and uncertain tax results: some companies will be discovered and too many others will be hidden.

It is disingenuous to pretend that market states provide nothing to businesses that make sales there. An educated, financially prosperous, secure market is essential for a business to prosper. Recent studies have shown that spending for higher quality schooling adds to the growth rate of Gross Domestic Product (GDP). State and local taxes pay for more than 90 percent of the costs of the education of its citizens. Clearly, this spending provides a direct benefit to companies making sales into a state, because higher incomes generated by educational investments yield higher sales and profits for those companies. Furthermore, states and local governments provide court systems that give remote sellers confidence to sell to consumers in other states knowing they can get recourse in courts in the customers' states and give customers the confidence to buy from remote sellers because the customers know they can get recourse in their own courts against the remote sellers. Finally, state and local governments provide roads and police and fire protection that ensure that the goods purchased from remote sellers will arrive safely.

The argument that companies selling into a state without a physical presence do not receive the benefits of public services from the market state is simply wrong. In analyzing the "no benefits without a physical presence argument," noted tax experts Walter Hellerstein and Charles McLure have stated:

> This line of reasoning is indefensible, whether the benefits corporations receive are defined broadly, to mean the ability to earn income, or defined more narrowly to mean specific benefits of public spending, one of which is the intangible but important ability to enforce contracts, without which commerce would be impossible. [2]

H.R. 3220 disrupts source taxation by preempting states from taxing companies that do business in or earn income from within a state, regardless of whether or not they have physical presence. However, even a company with major physical presence in a state can still shift income away from that state. Under HR 3220, a company can create a subsidiary to hold intangibles such as its trademarks that are then licensed to the in-state stores. A company can have a significant number of employees in a state earning income and assign those employees to an out-of-state subsidiary to avoid taxation. A company could even have a building located in a state, but benefit from tax-planning opportunities in the legislation to avoid state taxes. These are just a few examples of physical presence that would be shielded from taxation under HR 3220 that would allow most, if not all, businesses to escape taxation.

HR 3220 would overturn well-developed law in many states which recognizes that a business that utilizes new technologies to exploit a state's market has no less presence in the state than a local business. Indeed, if presence is measured by sales an out-of-state company may well have a greater presence in a state's economy than a large number of small, local businesses including those with which it directly competes. The legislation would preempt state jurisdiction to tax based on the use of intangible property in a state or sales made into a state. Both out-of-state and local businesses benefit from and impose costs on state services such as education, commercial laws, the state judicial system, and police protections, for which each business should pay its fair share. To exempt remote business from the obligation to contribute to the infrastructures and place the entire burden on local businesses would allow remote businesses to earn significant income in a state without making any contribution toward state services it receives or costs it imposes on a state.

IV. Tax Policy Considerations

a. HR 3220 promotes tax sheltering that would shift the tax burden unfairly to local businesses. HR 3220 is bad tax policy—it is neither simple, efficient or equitable. It would legitimize tax sheltering strategies that some multistate businesses use to shift income artificially out of the state where it was earned to a state or foreign country that does not tax that income.[3] Indeed, it will even require public companies that currently disdain tax sheltering to shift income in this manner because of the fiduciary duty of the company's officers to

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[2] Charles E. McLure and Walter Hellerstein, "Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals, *State Tax Notes*, March 1, 2004.

[3] In plain terms, "tax sheltering" for state tax purposes means here that income is not being reported in proportion to the business activity in the state that gave rise to the income. Instead, the income is being shifted to other locations. Tax sheltering may or may not be technically legal in various instances, but all tax sheltering falls short of the policy standard of the Uniform Division for Tax Purposes Act that income should be reported to states so that it "fairly represents" where the business activity giving rise to that income occurs. Tax sheltering is to be distinguished from legitimate tax planning which involves changing real business activity—the location of jobs, facilities or sales—among states to take advantage of lower tax rates.

shareholders to reduce the company's tax liability. The result will be that multistate companies would secure a tax reduction to the disadvantage of purely local businesses. The Congressional Research Service recognized this failing of HR 3220 in its recent analysis stating: "The new regulations as proposed in H.R. 3220 could exacerbate underlying inefficiencies because the threshold for business—the 21-day rule, higher than currently exists in most states—would increase opportunities for tax planning leading to more "nowhere income". In addition, expanding the number of transactions that are covered by P.L. 86-272 also expands the opportunities for tax planning and thus tax avoidance and possible evasion."[4]

b. HR 3220 would have the effect of stifling economic development. HR 3220 creates a number of winners but also many losers in the business world. Some corporations could escape tax liability in every state where it does business except in the state of the corporation's domicile. The result is that more of the tax burden is shifted onto small businesses with few resources and local businesses which will almost certainly reduce—or even eliminate—their ability to compete in the marketplace. Most importantly, HR 3220 could freeze economic development in place as more and more businesses seek to minimize their physical presence in a taxing jurisdiction. If a physical presence standard were established, companies would have a disincentive to move jobs and investments into states where they have customers. Under a physical presence regime, a company making investments in a state into which they market would suddenly face a new business tax liability. Under the existing "doing business" standard, the company should already be paying income taxes to that state. A physical presence standard would have the ironic and highly negative economic effect of inhibiting the free flow of investment across state boundaries.

c. HR 3220 adds complexity to state tax laws and insures years of litigation. Supporters of HR 3220 claim the legislation's physical presence requirement establishes a "bright line" for determining whether a business does or does not have nexus with a state. Certain provisions in the proposed legislation belie this assertion—they are neither a physical presence test nor a bright line test. Rather, HR 3220 contains a myriad of provisions that would allow businesses to establish a physical presence in a state and yet escape business activity tax liability altogether.

Examples of the inequities created by the legislation abound. The physical presence exception granted to businesses engaged in gathering news and event coverage is illustrative. This provision would allow an out-of-state news organization to locate substantial amounts of real and tangible property and employees in a state yet escape business activity tax liability. This is unfair to in-state taxpayers and also other out-of-state taxpayers who would remain subject to a state's business activity tax solely as the result of engaging in a type of business which would not be protected by HR 3220.

H.R. 3220's requirement that a business be physically present in a state in order to be subject to business activity taxes allows companies to shift income earned in a jurisdiction where they are physically present to a jurisdiction that imposes no business activity tax. A company could set up a subsidiary holding company in a no-tax state, and transfer ownership of its intangible assets-

[4] Congressional Research Service,"State Corporate Income Taxes: A Description and Analysis", March 23, 2004, p. 14.

trademarks, patents and the like-to its subsidiary. The subsidiary then licenses the use of such intangibles back to the parent, for which it receives royalties from the parent company. The parent continues to do business in states where it has both a physical presence and sales, but the income earned is shifted out of the state in the form of royalties to the subsidiary holding company.

The interplay between sections of the legislation excepting certain activities in a state from the physical presence rule and those excepting certain kinds of tangible property present in a state is also unfair to businesses that do not participate in such activities, or that own property for different purposes than that allowed by the exception.

For example, the exception to the physical presence rule allowing the presence of employees in a state who meet with government officials for purposes other than selling goods or services permits that out-of-state company to own substantial property as long as that property is used to meet with government officials. A lobbying concern could own retreat facilities, conference facilities or even a condominium for use by the employees when they visit a state to lobby.

The nexus exception pertaining to the presence of tangible property owned by a nonresident company located in a state for purposes of being manufactured, assembled and the like is also unfair to other out-of-state businesses that own similar property that is present in a state for different reasons. A nonresident company could own millions of dollars of property in the form of hazardous materials, machinery components, etc. in a state, which imposes a significant cost to the state in the form of services the state provides, such as police and fire protection. Yet, under this provision, that company escapes paying its fair share of a portion of the service the state renders.

HR 3220 is bad tax policy because it violates a major canon of good tax policy articulated by Adam Smith more than 225 years ago—tax neutrality—taxes should interfere as little as possible with business decisions. H.R. 3220 violates this important principle by influencing the way a business organizes itself and influencing a firm's choice of location. H.R. 3220 subsidizes the activities of out-of-state businesses and shifts a greater burden of taxation onto local businesses and individual taxpayers.

V. HR 3220 Would Overrule Tax Laws in Virtually Every State Based on Economic Activity

HR 3220 would overrule state and local laws currently in effect in virtually every state. HR 3220 applies not only to the corporate income tax, but to other business activity taxes such as public utility gross receipts taxes and gross receipts taxes such as the Washington State Business and Occupations Tax. With a very few exceptions, most states and localities impose at least one business activity tax as a result of economic activity irrespective of whether the company has a physical presence. For example, Maryland imposes its corporate income tax to the full extent allowed by the U.S. Constitution. Nexus exists in New Mexico when a corporation transacts business in or into New Mexico or has a corporate franchise in the state. In South Carolina, every C corporation doing business in the state is subject to the corporate income tax. "Doing business" is defined as the operation of any business enterprise or activity in South Carolina for

economic gain. Maryland, South Carolina, and New Mexico have successfully defended their economic presence nexus standard against Commerce Clause challenges in their state court systems; the United States Supreme Court has denied review of the Maryland and South Carolina cases. HR 3220 would statutorily overrule both the state tax statutes in these states and the judicial decisions that have sustained the statutes against constitutional challenge. Congress should respect the considered judgment of state legislatures and courts and not impose such an ill-advised jurisdictional requirement on the states.

VI. Possible Solutions

In context, HR 3220 is an overreaching proposal that seeks to resolve an issue absent consideration of fact, analysis, or current law. While businesses have provided several limited examples of controversy with state revenue departments, revenue commissioners have reported few current instances of taxpayer complaints relating to assessment of business activity taxes. Regardless of the perceived extent of the problem, finding a solution to the problem—if one is needed—is a matter best left to states and businesses themselves.

There is ample recent history of states and businesses working together to find solutions to tax and non-tax issues. In 2001, states, local governments, and the telecommunications industry successfully completed negotiations to formulate sourcing rules for mobile telecommunications services. These rules have now been adopted by more than 30 states and ratified by Congress. Similarly, states, local governments, and businesses are in the midst of a multi-year cooperative effort to modernize, streamline, and simplify state and local sales tax laws as a part of the Streamlined Sales Tax Project. Once completed, this effort will result in administrative cost savings to both sellers and states and provide a mechanism to insure a level playing field among all sellers in the marketplace. Similarly, rulemaking—on tax and non-tax issues--undertaken by states involves substantial input and consultation with the business community.

The sourcing and sales tax projects are examples of specialized, highly technical areas of state tax law that challenged states and businesses in negotiating solutions that resulted in fairness and equity to all parties. Any attempt to revise current state business activity tax laws commands the same consideration. As business operations evolve and recognizing the needs of both states and the business community for continual refinement in the business activity tax area, the Commission has already developed a proposal for consideration. In 2002, the Commission adopted Policy Statement 02-02, which sets forth the Commission's views on the economic presence standard for imposition of business activity taxes. Policy Statement 02-02 also includes the Commission's Factor Presence Nexus Standard for Business Activity Taxes, which bases a company's liability for business activity taxes on a threshold amount of a company's property, payroll, or sales in a state. The Factor Presence Standard is a fair, balanced approach to imposition of business activity taxes that provides equity between in-state and out-of-state businesses while eliminating instances of double taxation or instances where businesses may be assessed tax for minor amounts of presence in a state. This standard would also make it clear, readily apparent and certain to both companies and tax agencies when a company would have nexus with a state—thus producing greater equity and uniformity in the actual application of the tax law to different businesses. In addition, the Commission has offered to initiate discussions between states and businesses, the goal of which would be to find common ground on simple,

clear, uniform nexus standard for business activity taxes. Thus far, the business community has been reluctant to engage in these discussions.

Ultimately, a cooperative effort by both states and businesses—one that includes a thorough analysis of current business activity tax nexus statutes as well as controversies that have arisen between businesses and states—is the best method for maintaining viable state tax systems.

We hope this information is helpful to the Subcommittee and its staff during its ongoing consideration of HR 3220. The Commission would welcome the opportunity to answer any questions that Subcommittee Members and staff may have.